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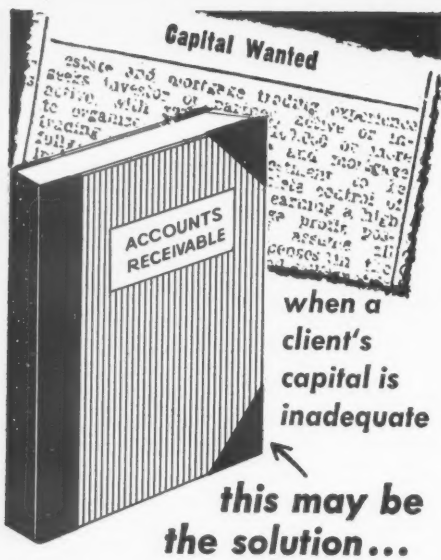
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BOOK REVIEWS

Studies in Costing

Edited by David Solomons. SWEET & MAXWELL, LIMITED, London, 1952. Pages: xii+643; \$5.95.

This volume represents twenty-six articles or studies on the subject of Costing, which the editor considers the best work in the field of industrial accounting during the last twenty years. These twenty-six studies are grouped as follows:

Historical—two studies; *Concepts of Cost and Costing*—five studies;

Costing as an Instrument of Planning and Pricing—nine studies;

Costing as an Instrument of Control—six studies; and

Costing in the Service of Government—four studies.

In order to obtain a diversified point of view on the subject of costing and also to develop a certain amount of balance in the presentation of the material, the editor has carefully selected the authors of his material. The authors may be grouped as follows:

Accountants or teachers of accounting—ten studies;

Economists or teachers of economics—eight studies;

National Association of Cost Accountants (U.S.A.), *Research Studies*—three studies;

Engineers—three studies;

Historian—one study; and

Lawyer—one study.

This selection of authors has resulted in presenting the points of view of the accountant, the economist, the engineer and the business administrator, and has done much to make this volume one of the most outstanding compilations in one volume that has appeared in many years.

The author or editor of this volume is a Reader in Accounting at the University of London, and this volume was edited in behalf of the Association of University Teachers of Accounting.

Perhaps the present public accountant, the present students, and also the teachers of cost accounting might be interested in this quotation from one of the economists whose study is in this volume:

"There are reasons for thinking that the whole basis of cost accounting as taught and practised in this country (England) has got into a rut, and that it needs completely rethinking in the light of recent economic theory."

I, for one, rather enjoyed this reference, and I know many of my friends in the field of economics will smile to have me note it. The fact that there are rather conflicting

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Book Reviews

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viewpoints in the field of cost accounting between the practicing cost accountant and the economist, does not mean that either is right or wrong. There are conditions under which both must and should be considered and applied.

The *Concepts of Costs and Costing* section includes discussions of such topics as historical costs, material costs, direct labor, manufacturing expense, depreciation, expense distribution, product costs, supplementary rates, normal capacity, standard costs, profit control from the accounting viewpoint; and price fixing and output decisions, by products, depreciation, interest on capital, and marginal costs from the economist's viewpoint.

Costing as an Instrument of Planning and Pricing covers such topics as short period price determination in theory and practice; accounting measurements of incremental cost; methods and potentialities of break-even analysis; the allocation of oncosts between departments; cost accounting and the use of space and equipment; fundamental aspects of the depreciation in a competitive industry; cost accounting and joint production; assignment of non-manufacturing costs for managerial decisions; the approach to budgetary control. This is an excellent section, well balanced in the selection of topics, and in the quality of materials.

Costing as an Instrument of Control covers such studies as accounting before the event; a reexamination of standard costs; developments in cost accounting with special reference to standard costing; critical areas of material cost control; current developments in industrial accountancy; and a case study of production and cost control. Because of its emphasis on standard costs in managerial control, this section is probably the most interesting and practical for the practicing accountant, cost accountant, and business administrator. It also has been carefully prepared in the selection of studies to provide the maximum of up-to-date material in a minimum of space.

Costing in the Service of Government covers studies under the heading of costing of government contracts; costing as a standard for price; costing in local government; and efficiency in the public transport of passengers. Although this section is interesting, it probably is the weakest section in an otherwise excellently prepared collection of current material on the subject of cost accounting.

It is highly recommended to all teachers in the field of cost accounting; to practicing accountants and to controllers and business administrators.

JOHN J. W. NEUNER

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Book Reviews

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Tax Shelter for the Family

By William J. Casey and J. K. Lasser.
BUSINESS REPORTS, INC., New York, N. Y.,
1953. Pages: 181; \$12.50.

Business Reports, Inc., has come out with an interesting study on the protection of family security from high taxes. This study of family tax sheltering devices has been heavily documented with statistical charts to illustrate graphically the powerful impact of federal taxes—income, estate and gift—in impairing the family pocketbook.

The purpose of the book is to present to the business executive checklists and ideas as to methods of improving family income to bridge more effectively the gap between family resources and security requirements. It is written in outline form with short, choppy, nontechnical phrases. The work is addressed primarily to taxpayers in the middle and high surtax brackets with annual income levels from \$20,000 to \$100,000. These taxpayers are advised at the outset, and properly so, that the tax devices presented offer possibilities only, which may or may not fit a particular factual situation. Messrs. Casey and Lasser, the co-authors, advise that any

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BOOK REVIEWS

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promising ideas culled from their study should be taken to a professional tax adviser for further checking against the taxpayer's particular situation and factual pattern.

The plan of presentation is good. First the general problem of family security is outlined with a statement of the broad strategy in conserving family income. This strategy of shifting income within the family by means of a family partnership, a family trust, a family corporation, a family foundation, or by a direct transfer within the family unit is then detailed in succeeding chapters. Tax consequences of the family trust and partnership are well and succinctly summarized with the income, estate, and gift tax considerations fully integrated. Although obviously not intended as a scholarly treatise on these important subjects, these chapters do merit more than a superficial reading. The study of family assignments is equally stimulating. On the question of shifting income to nontaxed family members, the reader is warned to study first the availability of tax deductions, offsetting losses, and exemptions within the family unit. The resultant denial of a dependency credit where income is shifted to an aged dependent parent might be easily offset by the availability in the family unit of additional tax deductions and additional exemptions for old age and blindness.

Unfortunately, not all the portions of the work are as detailed as the chapters dealing with family assignments, trusts and partnerships. The short chapter on family insurance presents, for the most part, a general survey of but a few of the principal considerations to be taken into account to effect maximum savings in the total tax burden. The chapter on separate and joint ownership is disappointing in its failure to accentuate one of the most common tax problems confronting the family unit, the tax disadvantages of joint ownership, particularly where substantial amounts are involved. There has been, and still is, a widespread sentimental practice of husband and wife holding property in their joint names, in spite of repeated urging by members of the Bar prominent in the field of estate planning to "leave the joint and split up." Survivorship rights as an incident of joint ownership create little flexibility for estate planning. Far more detrimental is the fact that when the first joint tenant dies, unless the survivor can affirmatively and fully prove that he contributed part of the proceeds, the full value of the property will be included in the deceased owner's estate for estate tax purposes. Income tax-wise the survivor does not fare any better for his cost basis of the property taken over is not the estate tax value, but the original purchase price.

In addition, the problem of incurring gift

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Book Reviews

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tax by taking title as joint tenants, a matter which can be easily overlooked by the average taxpayer, is not adequately explored in the study.

The book contains numerous judicial citations although, in the interests of brevity and nontechnical presentation, the authors have omitted references to the law and regulations. This lack of the complete citations customarily found in tax studies tends to make some of the tax ideas and devices presented appear to be somewhat artificial. The reader is given basic short principles of a highly stimulating tax avoidance quality; their application must of course be left to the taxpayer's own ingenuity.

If the work is viewed as being primarily suggestive, rather than authoritative, it can serve a highly useful purpose in stimulating taxpayers to conscientious tax planning. Tax Shelter for the Family is after all a subject which does have a tremendous appeal to the tax burdened family breadwinner.

SAMUEL A. DYCKMAN

New York, N. Y.

The Plant Accounting Regulations of the Federal Power Commission

By Sidney Davidson. UNIVERSITY OF MICHIGAN PRESS, Ann Arbor, Michigan, 1952. Pages: 163; \$2.00.

The plant accounting regulations of the Federal Power Commission have been the subject of much controversy ever since they were first promulgated. Professor Davidson in his book presents a thorough study and discussion of the regulations and related decisions of the Commission with respect to Account 100.5—Plant Acquisition Adjustments; Account 107—Electric Plant Adjustments; Transactions with Associated Companies; Reaccounting; and Depreciation Accounting. A concise summary of his suggestions and conclusions is furnished together with references to source material conveniently classified.

Professor Davidson gives credit as to good features and suggests modifications where he believes they are warranted. His approach is designed to afford equitable treatment to consumers and security holders alike. He believes that the Federal Power Commission's program has been unduly harsh in certain respects and has been so administered as to require conformance to a set pattern irrespective of the facts and circumstances of the particular case. His views in this connection are summed up in the following statement:

"Correction of past abuses is not secured

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EMANUEL SAXE, *Managing Editor*

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VOL. XXIII

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No. 6

Robert H. Montgomery (1872-1953)

This beautiful tribute to the memory of the late Colonel Robert H. Montgomery was written by one of his partners, Mr. Louis H. Rappaport, who is a regular contributor to our magazine.

ON May 2, 1953, Colonel Robert H. Montgomery died quietly at his Florida home at the age of 80 years. With his passing, the accountancy profession lost one of its truly great members whose entire career was practically synonymous with the growth of public accountancy in the United States. Few persons—living or dead—have made such important contributions to their profession as did Colonel Montgomery. Few persons have earned a more secure niche in the Accounting Hall of Fame. The man and his works exerted and will continue to exert a profound influence on the profession of accountancy in this country.

Colonel Montgomery went to work in the office of a public accounting firm in 1889 in Philadelphia at the age of 16. Nine years later he was one of the founding partners of the firm of Lybrand, Ross Bros. & Montgomery. A man of boundless energy, he added the study of law to the active practice of accountancy. Despite the fact that his study of necessity was done at night and on trains while traveling between out-of-town engagements, he was graduated in the top bracket of his class and was admitted to the Philadelphia Bar in 1900.

He opened the New York office of his firm in 1902 and later became an

instructor in accounting at Columbia University. He was deeply interested in teaching and remained with the university until 1931 at which time he was a Professor of Accounting. During his affiliation with the university he had accumulated a large and valuable collection of books on accounting subjects. Some of these were exceedingly old and rare, and he contributed the entire collection to Columbia where it is now known as the Montgomery Library. Also while he was at Columbia, Colonel Montgomery endowed a fund, the income of which was to be given each year to the graduate of the School of Business who majors in accounting and is deemed to be most proficient in all subjects. Each year a Columbia graduate is agreeably surprised when he learns that he has won the Montgomery Prize in Accounting.

It was his teaching activity that launched Colonel Montgomery on his career as an author. There was no adequate American literature on accounting at the time, and Colonel Montgomery's classes used a standard English work, Dicksee's "Auditing." Based on English practice, this book contained many references which were not relevant to American practice. Colonel Montgomery undertook the

preparation of an American edition of Dicksee's book. Subsequent editions of this book became more and more "Montgomery" and less Dicksee and, in 1912, a completely independent book was published, the first edition of Montgomery's "Auditing Theory and Practice." Seven editions of this book have been published, the last in 1949, and each has been recognized as an authoritative source of information as to what constituted generally accepted accounting practice. Each year the Institute makes an award to the author of the outstanding book or article in the field of accounting. In 1949 the award was made to Colonel Montgomery for his book, Montgomery's "Auditing." This book, said the Committee on Awards, "has been considered by many to be the 'Bible' on the subject."

The adoption by the federal government of the income tax as an important source of revenue had an important influence on Colonel Montgomery. He became interested in income tax practice and came to be recognized as one of the leading authorities in that field. This interest led to his publishing, in 1917, Montgomery's "Federal Income Tax Procedures." Successive editions of this publication have each been recognized as unique and invaluable aids to tax practitioners.

In 1950, Ohio State University established an Accounting Hall of Fame to which there is elected each year one or more persons who have made outstanding contributions to the field of accounting. Nominations and elections are made by a group of prominent accounting educators, public accountants and industrial accountants. In the first year of its establishment Colonel Montgomery was elected to the Accounting Hall of Fame.

During World War I he was appointed Chief of the section on Organization and Methods in the office of the Chief of Staff of the U. S. Army and was also a member of the War Department Board of Appraisers and Price

Fixing. His ability in organization and finance led to his appointment, in 1921, as Assistant to the Chairman of the Board of the U. S. Shipping Board in charge of finance and accounts. In this capacity he introduced modern business methods to the affairs of the sprawling Board and effected annual savings of \$2,500,000 in costs of administration, a not inconsiderable sum in those days.

Throughout his life Colonel Montgomery was active in professional organizations. As President of the American Institute of Accountants he was largely instrumental in effecting the merger of the Institute and the American Society of Certified Public Accountants. He also served as President of the New York State Society of Certified Public Accountants. He was a contributor to the first International Congress on Accounting held in St. Louis in 1904, and largely through his initiative the International Congress on Accounting held in New York in 1929 was organized. Colonel Montgomery was president of the 1929 Congress.

In 1937, the Institute was 50 years old and marked the occasion with a five-day celebration in New York. People from all over the world were registered at the anniversary celebration, and attendance at some of the events was as high as 2,500. In a real sense it was another International Congress on Accounting and was presided over by Colonel Montgomery, the then president of the Institute.

In the midst of all his other activities, Colonel Montgomery helped to organize the Accountants Club of America in 1926. As the first president of that group he had the opportunity to translate into action the purpose for which the Club had been formed, namely, to foster friendship and closer association among fellow practitioners. Time and again he invited all the members of the Club to be his guests at his homes in Connecticut and Florida.

Colonel Montgomery played golf for many years and enjoyed it enormously. But his first love was horticulture, and

he gave to it all the energy, drive and enthusiasm he possessed. At his home in Connecticut, on an estate of 100 acres, he gathered from all over the country the finest collection of coniferous trees in the East. Only a few years ago he contributed about 400 of these trees from the collection to the New York Botanical Garden, where they form the Montgomery Collection of Conifers. In recognition of his outstanding contributions to the advancement of horticulture and botanical science, the Garden, in 1951, presented him with its Distinguished Service Award.

In 1935, he purchased 80 acres of land near his home in Coconut Grove, Florida, and donated the land for the establishment of a botanical garden in honor of Dr. David Fairchild, world famous plant explorer. Colonel Montgomery donated large sums of money plus hundreds of palms and other trees to the Garden which now contains the largest collection of palm trees to be seen anywhere in the United States.

The Garden is open to the public and each year thousands of persons enjoy the trees and plants on display there.

A man of Colonel Montgomery's stature had many facets of character. Two that stood out were his intellectual honesty and the virility of his mind. These are best expressed in his own words in the preface to the Seventh Edition of his "Auditing Theory & Practice". Speaking of the duties of an auditor he said, referring to the first edition of that work, "I find that I then stated the prime purpose of auditing to be the discovery and disclosure of truth. I have consistently adhered to that belief." In discussing the need for a dynamic mental attitude on the part of the profession, he said, "If our profession is to avoid stagnation, it must keep alert to the necessity of reexamining these assumptions from time to time to establish their validity under current conditions. . . . It is foolish to cling to accounting principles for no better reason than that they exist."

The following is the text of the moving memorial prepared and read by Colonel Andrew Stewart in memory of the late Colonel Montgomery at the 1953 Annual Meeting of the Society.

IT is with a sense of personal loss that I arise to pay tribute to the memory of one of the finest and most beloved of our profession, a former President of our own Society, Colonel Robert H. Montgomery.

We, who knew him, loved, respected and esteemed him and he will always live in our hearts and memories.

It is impossible for me in the time allotted to do more than touch on a few of his many great accomplishments and personal qualities which have made him so outstanding a figure in our profession since the turn of the century. His contributions as an author and teacher will go down in history as a lasting memorial. Yet, we who have known him intimately will remember him more for

his human qualities, his devotion to the interests of our profession, his unstinted sacrifices to serve his profession, and his leadership in the highest offices with which our profession could honor him. In retrospect, no one of these accomplishments seems to stand out above the others. But it is a significant tribute to his eminent ability that, in spite of his busy professional and educational life, he found time to assume and handle to perfection any task or high office assigned to him by the profession.

Out of these activities there stands like a beacon the power of his foresight and continued influence on the development of the profession. As early as 1904 he was an advocate of one national

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society to represent the profession. In that year he was quoted as follows:

"I feel however, that it is incumbent upon the present generation to build for the future and am anxious to see fulfilled at the earliest possible date that hope which so many have just now—One National Federation or Association, One society in each state and All working together for the highest ideals which alone will bring respect from our clients—the public."

In 1921, when the American Society of Certified Public Accountants was formed, he felt that a great mistake had been made, and in his report as President of our Society, in 1923, he repeated the statement with added and convincing arguments. In 1935, when asked to accept the nomination for President of the American Institute of Accountants, with typical courage and foresight he refused to run except on a clear-cut platform of merger with the American Society. Elected by an overwhelming vote, he was responsible for carrying out the merger during his term of office. This accomplishment alone was one of the greatest forward steps in the phenomenal development of our profession which followed.

In our own Society, he served as First Vice-President in 1921 and as President in 1922 and 1923. His term of office saw an amazing increase in the activities of the Society, including the field of technical committees which brought many younger men into active work in the Society and a substantial increase in the attendances at meetings, largely because it was known that no meeting at which he presided would be dull or uninteresting.

His place in International Congresses on Accounting must be mentioned. He attended and was a contributor to the first International Congress on Accounting in St. Louis in 1904. Through his initiative the International Congress

on Accounting held in New York in 1929 was organized. Those who worked with him on that Congress will long remember his organizational ability, his unequalled talent for selection of committees, and his eminent success in bringing all details of the Congress to a successful conclusion.

His services, to his government, both in time of war and peace, are well known and need not be described in detail.

In 1926 Colonel Montgomery gave to Columbia University his collection of old and rare accounting books, which had taken him many years to assemble. Of this collection, known as the Montgomery Library, the Director of Libraries of Columbia University, has stated:

"There are no other libraries on this continent that can compare with it in wealth of accounting history materials."

In the midst of all these other activities he found time in 1926 to bring into fruition the Accountants Club of America, originally proposed by Elijah Watt Sells. As the first President of that Club, he had an opportunity to carry out his great desire for closer association with his fellow practitioners. The time and effort which he spent in the following years on that organization is reflected in the virility of the Club as it is today.

Those who attended his last rites in the garden of his lovely home in Coconut Grove were impressed by the beauty of the scene as a fitting climax to a life of high ideals and major accomplishments, and we must have pondered as we gazed respectfully at his bier covered with garlands of orchids—There goes a great leader whose steady influence, dependable insight, and personal charm will long be missed.

May his soul rest in peace!

Free Minds For A Free Society

By BUELL G. GALLAGHER, Ph.D., D.D.

"There must be absolute trust and faith in the integrity and impartial position of the financial reporter as a man who will investigate with detachment in a society that protects his right of inquiry. . . . As long as he acts as a responsible man, thinking of the general welfare, and conscientiously pursuing it, he will contribute to the good society and the good life. As a free man with a free mind, he will be a builder of the free world."

THIS "C.P.A. Candidates' Dinner" is very much like the Commencement exercises which mark the conclusion of collegiate training. And like Commencement, it is a good time to recall to members of the profession—both new and old—some of the fundamental matters of the calling to which they are called.

Every June, the thousands of young men and women who are graduated from The City College rise and solemnly swear the Ephebic Oath which was sworn by the youth of ancient Athens on assuming majority. In somewhat that same solemn spirit, I address this dinner tonight. I speak of the meaning of the profession of accountancy, and of the character and temper which must go into that profession if its full responsibility is to be discharged.

My topic is announced as "Free

Minds For a Free Society." Some may have assumed that I intended to use this dinner as a sounding board for another pronouncement on academic freedom. On the contrary, I intend to speak to the significance of this profession in the service of a free society—for the necessity of freedom is by no means limited to the halls of academic learning.

Our nation is a constitutional society. Our freedoms are those which are guaranteed by the constitution, and our obligations are those which attend upon the guaranteed freedoms. This simple fact—simple to us, in this day, but of revolutionary significance in 1787—this simple fact has far reaching ramifications. Among other things, it determines the character of professional performance demanded in all pursuits, including accountancy.

Look at the facts and see whether this is not so.

The writing down of the fundamental law, beyond peradventure and against misunderstanding, is one of the most important political inventions of all time. It puts the basis of government squarely on exact and enduring language.

The Idea of Constitutionality

Three elementary notions are combined in the idea of constitutionality:

a. *A Greater Law.* Instead of a monarch or a dictator, ruling either by divine right or by his own might, the law is superior to the ruler—whoever he may be; and he is held accountable

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This address was delivered by Dr. Gallagher on May 4, 1953, at the dinner held by the Society in honor of the successful candidates at the November, 1952, New York CPA examination.

under that law. Constitutionality means a government of law, not of men.

b. *Individual Rights.* Previous to constitutionalism as a working principle of government, the only persons who enjoyed any individual rights were those who had been granted specified rights at the pleasure of the sovereign. There was a centuries-long struggle to establish the Rights of Man in the face of the Rights of Kings; and the writing of these rights into a constitution is a basic step in constitutionalism.

c. *A Charter.* Beginning with Magna Charta, the practice has developed of putting in writing the things which were to be regarded as irrevocable or inalienable rights of men, the things which the ruling sovereign could not violate. This writing down of the basic agreements on which government rests finally culminated in the writing of the American constitution.

Growth and Development of Constitutionalism

The provisional character of the first federation of the American colonies left much to be desired. It was in 1787, that constitutionalism emerged full blown as a national fact. And constitutionalism has, in the intervening years, gone through three phases. It promises now to emerge into a fourth stage of development.

1. The Beginnings

The Constitution of the United States was written in a period of reaction following the Revolution. Those who drafted the document and signed it were gentlemen of substance and standing. They were concerned with consolidating the gains of the Revolution and establishing a basis on which peaceful processes should take care of all future eventualities because the fundamental rights of men were safeguarded. The convention in Philadelphia met behind closed doors. The long process of debate and revision produced a document which was wholly

satisfactory to none of its signers. It was the best compromise they could strike. And the final ratification was made possible only by the addition of very precisely worded amendments comprising the Bill of Rights. In the heat of a Philadelphia summer, bothered with the flies so badly that they had to adjourn to the open air, a group of young men averaging 43 years of age, by wrangling, argument, discussion, and revision finally arrived at a draft on which they agreed. Altogether the writing of the Constitution was a very human process, and ought always so to be remembered.

2. The Enshrinement

The second phase of constitutionalism began almost as soon as the ink was dry. Appealing to its authority, men began to ascribe to the Constitution a sort of divine origin. This was the era of the aging Chief Justice John Marshall, of the oratory of Webster and the famous *Reply to Hayne*. Out of this effort comes the notion of "the greatest document ever struck off at a moment by the hand of man."

The Constitution thus became to political life what the Bible is to religious fundamentalism. It was a source of proof texts from which trained men could, by exegesis, draw applications to the affairs of men. As time lengthened, each added decision of courts and law gave greater weight to the authority and dignity of the Constitution, until it came to be the object of veneration as well as the source of vindication.

The document came to be looked upon as the most perfect instrument of government ever contrived; its foundations rested on the everlasting rock of impartial justice for all. Orators endowed it with a multiple essence: a great spirit, a divine rule and command, a high altar, a faithful mirror of the nation's heart, an impenetrable fortress guarding the gates of freedom, and many other wonderful attributes besides. Like the Ten Commandments,

it was to be learned, understood, and accepted. It was even whispered by some that it ought to be obeyed! The Constitution was enshrined and entrenched.

3. The Perversion

The third phase of constitutionalism—and notice, I am talking not about the Constitution, but about an *ism* based on it—the third phase of Constitutionalism is the perversion of the second.

Wherever an infallible authority is established, there are never wanting those who would attempt to use its unassailable power for their own private and personal ends. Orders, leagues, associations, sprang up. Some had as their object the crushing of trade unionism. Others wanted to use the constitution to keep aliens away. Others fronted for business interests, talking of States' rights but meaning something else. The one characteristic common to all these is the attempt to throw the cloak of Constitutional infallibility over their own shoulders and gather to themselves the aura of authority.

We have not seen the end of this process of attempted perversion. It can be checked only with eternal vigilance.

4. Delineation

Meantime, another and contrary process goes on—the process of actually defining what the Constitution means in practice, and what its guarantees are. Despite the narrow faith of constitutional fundamentalism, the Constitution itself has grown and developed and, in the main, served our democracy magnificently well.

It began by taking caprice out of government and giving all men a dependable floor of carefully defined law on which their rights and prerogatives could rest. This is the meaning of a government of laws, not of men.

In the nature of the case, the actual

application of the meanings of the written word had to be left to interpretation. That is where the courts have come in. The job of the Supreme Court in interpreting the constitution is a far from easy one. It is the task of tracing a delicately defined and carefully maintained line of succession and precedent, gradually broadening and solidifying the constitutional base of American law and life.

Part of the hazard of this problem has been semantic. Words do not pass current in succeeding generations with continuing meaning. And changing attitudes are reflected in modified decisions. Likewise, these changing attitudes have their counterpart in changing circumstances. The complex industrial society of today was not foreseen by the framers of the constitution. In 1787, few had dreamed of the profession of accountancy. Of the nearly two thousand occupations and professions now listed officially by the Department of Labor, scarcely a score were in existence in 1787. The whole corporate structure of modern finance capitalism was yet to develop. New problems have had to be met with principles and ideas based on the fundamental law but not written into it.

Thus the 14th Amendment was designed to protect the rights of persons who had been slaves. It became the legal means of ascribing personality to corporations and of protecting the rights of corporations as legal persons.

Justices have had to draw heavily on the common law as it stands alongside statutes and the written constitution. And justices have had to discover new principles of law not yet written into the constitution, yet given constitutional force by their decisions. Thus, for example, although the Constitution is silent in the matter, it is now an established principle of constitutional law that States cannot tax an instrumentality of the Federal Government. And so it comes about that the Constitution itself is a brief document, but the law of the Constitution lies scat-

tered in a series of reports which runs well on toward 300 volumes.

One of the results has been that the courts have actually taken on what might otherwise have been legislative functions. The Court rules that Congress can avert a nationwide strike by imposing settlement on the railroads, defending its action by saying that the power thus to act had been lying dormant all the time. Employing a legal formula, the Court marks out the boundaries of governmental action. And thus Constitutionalism becomes a complex operation of government itself.

Constitutional Government Is a Human Process

Now, the point of the matter is that all of these things have to be done by men. The Constitution itself was written by men. Each and every interpretation and application of that basic document, every development to meet new situations, every use of constitutional safeguards and permissions, every application of constitutional principles, every appeal to constitutional authority—all of these are designed by men and carried out by men. There is no mystery in the matter. It is a human process.

I, for one, am glad that this is so. We must never forget the fact that the frailties of human nature are involved in this most important of legal processes. Such remembrance is one way to make sure that the foundation of our national life does not become its strait-jacket. Room for growth remains.

Some centuries ago, the Greek City of Ionia was about to found a colony. A certain lawyer named Charondas was commissioned to draw up its constitution. His work was thought to be perfect, incapable of improvement. But to make improvement theoretically possible, a clause was added, permitting any man to propose a change in the Constitution if he so desired. All he had to do was to enter the assembly with a rope around his neck—and if his

proposal were rejected, he was to be hanged on the spot! It is good that we do not take a similar attitude toward our Constitution. Twenty-one times we have amended it through formal action; and many more times than that, its meaning has been amended through judicial process.

Importance of Integrity and Understanding in the Judicial or Quasi-judicial Process

The conclusions I draw from this discussion are so obvious as hardly to need stating. Since our fundamental freedoms, our whole life as a nation and a society, rest on a man-made document which is constantly being applied, interpreted, and revised by men, the basically important factor in the equation is the character and purpose of those men. Judge Learned Hand has rightly appealed for a broadly educated judicial bench, in order that those who apply the law may do so with the widest understanding of human values. So, also, we have a right to expect that all who function in a judicial or quasi-judicial character shall be men of breadth and of depth, of human understanding, and of integrity.

I return to the analogy between a government based on a written document and a religion based on a written book. In both instances, everything depends upon those who interpret the meanings and make the applications to developing circumstances. Much depends on the integrity of the men chosen to husband and to safeguard and to draw out, meeting the challenge of each new hour with the distilled wisdom of experience, and yet protecting the hopes of the unborn future.

Responsibility of CPAs as Guardians of Freedom for a Free Society

If this has seemed a long journey in the effort to reach the meanings which are relevant to this new crop of Certified Public Accountants, let me assure

you that the end has come. It will be brief, sharp—and, I hope, just a little uncomfortable.

In a recent editorial, the *Journal of Accountancy* said:

"Above all, the certified public accountants who act as independent auditors must assert and reassert their *impartial and judicial position*."

I take these words to mean just what they say, and I conclude that the responsibility rests on accountants, in precisely the same way that it rests on judges, to be the guardians of freedom for a free society. The only way in which a free society can live is for all of its components to be free—responsibly free.

The Role of the CPA in the Democratic Process

The CPA might well stand as the symbol of the American faith in the democratic process. Not to be controlled by the whims of capricious and willful men—this is an essential part of democracy. To be free, society must be protected by men whose minds are free and unprejudiced. There must be absolute trust and faith in the integrity and impartial position of the financial reporter as a man who will investigate with detachment in a society that protects his right of inquiry.

Public confidence and trust must first be won in order to secure the rights of free inquiry. The accountant must

not assume the role of apologist or hireling of the firms and corporations whose accounts he audits. He must often serve in the harsh role of management's critic for management's own good. Similarly, democracy is often best served by those who accept the role of criticizing the flaws in democratic procedure, pointing the way to constructive improvement.

And just as a free society can be secure only as jurists of integrity interpret and apply its constitutional processes, so, too, the quasi-judicial character of the accounting profession puts it under special obligation if free men are to continue in a free society.

To simple and incorruptible honesty must be added a high degree of social sympathy, of sensitivity to the needs and hopes and aspirations of the common man. Integrity must be enkindled with passion for humanity, if men are to be free and secure.

Let none of these new CPA's think that he enters on a profession whose processes are merely mechanical. Over and over again, he will discover that his actions depend not on some written rule, some law, some regulation—but on his own interpretation of these written materials. As long as he acts as a responsible man, thinking of the general welfare, and conscientiously pursuing it, he will contribute to the good society and the good life. As a free man with a free mind, he will be a builder of the free world.



The Special-Problem Report

By CHARLES W. LAMDEN, C.P.A.

Most statements of accounting principles were developed with the preparation of corporate commercial financial reports as their basic objective. Apparently, "special-problem reports" have been considered to involve exceptions to the rules. Taking the view that the need for establishing some kind of accounting guideposts for these reports has become more and more pronounced, this paper surveys the question and makes specific recommendations for report writing procedures in special-problem situations.

Significance of Accounting Principles in Report Writing

One of the basic elements in the preparation of accountants' reports is the determination of whether the financial statements have been prepared in accordance with generally accepted accounting principles. Because of the emphasis on accounting principles, it has been necessary for the accounting profession to seek a "philosophy of accounting" and to eliminate, as far as possible, conflicting and irreconcilable treatment of identical transactions. This has led to the development of an extensive body of authoritative literature with respect to accounting principles and to significant formalization of accounting procedures.

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This paper was presented by Dr. Lamden at the 1952 Graduate Accounting Study Conference of the California Society of CPAs and also appeared in the May, 1953, issue of *The California Certified Public Accountant*.

The effect of the recent developments has been the formulation of certain standard procedures; there has not been standardization in the sense of complete uniformity of practice and procedure. Primarily, criteria have been established in connection with the use of many of the accountant's most important categories such as "revenue," "costs," "net income for the year," "fixed assets," and "retained income." Criteria have also been established for allocating particular items to one category or another or to one accounting period or another. In addition, the areas of variation in principles and the areas in which no criteria have been established have been reduced. Generally speaking, there has emerged a system of rules and principles and a system of standard techniques and procedures which transcend the authority of individual accountants and business management.

The development of greater uniformity in accounting principles has not been the result of a sudden change; it has taken a long time and is still in process. Nonetheless, today, an audit report that refers to generally accepted accounting principles has a definite implication or meaning for all professional accountants, for most bankers, for many investors, and for other groups. Whether it carries the same implications to all groups is still open to question. But the fact that there is a recognized body of concepts, called accounting principles, rather than many varied groups of concepts with many shades of meaning, at least so far as account-

ants are concerned, has meant real progress.

Inadequacy of Established Principles for Certain Reports

A careful analysis of various statements of accounting principles makes it evident that they were developed with the preparation of corporate commercial financial reports as their basic objective. They were not designed for the types of reports that will be designated here as "special-problem reports." For example, the statement of the American Accounting Association is entitled "Concepts and Standards Underlying Corporate Financial Statements." This would seem to exclude their application to all other types of organizations for whom financial reports are prepared. Similarly, most of the bulletins of the American Institute of Accountants apply specifically to business corporations.

Apparently "special-problem reports" have been considered to involve "exceptions to the rules." During the past few years the need for establishing some kind of accounting guide posts for the preparation of reports involving these "exceptions" has become more and more pronounced.

A brief review of the following list of organizations which require "special-problem accounting reports" indicates the importance of financial reports to which accounting principles set forth for commercial corporate enterprises do not apply specifically.

Municipal and other government organizations
Educational institutions
Charitable and fund raising institutions
Social, professional, and service clubs; fraternities; similar organizations
Farming and other agricultural organizations
Professional firms
Organizations deriving income from rents, royalties, and dividends
Other enterprises keeping records on a cash basis

Trends in Special-Problem Reports

There have been a number of rather definite trends in the preparation of "special-problem reports." These trends may be summarized as follows:

1. The more clearly defined procedures for accounting, auditing, and reporting for corporations have been adapted in most instances, at least where they are applicable, to the "special-problem reports."

2. Most accountants have recognized that even though cash-basis accounting may have advantages in particular organizations for purposes of record-keeping, the failure to disclose material assets or liabilities as the result of accounting on the cash basis makes it necessary to qualify their reports, if an opinion report is prepared.

3. There has been an effort on the part of accountants responsible for the preparation of reports for some of the special groups to develop standards specifically applicable to their area and to set forth criteria which may be used for disclosing special information distinguishing their accounting, auditing, and reporting procedures from those of corporate entities.

4. Professional accountants are giving more attention to reporting for proprietorships and small businesses. Also, banks, credit grantors and others are demanding higher standards of accounting, including opinion reports, from small businesses. In general, many small businesses have begun to recognize and appreciate the values of the more extensive accounting procedures required for opinion reports, and certified public accountants are giving more careful attention to procedures for servicing small business.

5. Over the past few years many governmental units, educational institutions, farmers, professional firms, and others have been converting many of their accounting procedures to the accrual basis. In the case of municipalities and educational institutions this has come about as the result of the activities of the organized national committees that have developed and set forth standard procedures. In other instances, organizations previously on a cash basis have found various advantages in converting to the accrual basis.

Requirements for Presenting Opinions or Disclaimers

In recent years the accounting profession has been attempting to strengthen the significance of financial reports and to increase their usefulness

to third parties. Consequently, it has been determined that whenever a certified public accountant allows his name to be associated with financial statements he must (1) express an unqualified opinion, (2) express a qualified opinion, (3) disclaim an opinion on the statements taken as a whole, or (4) indicate that the statements were prepared without audit. The details of these requirements have been set forth in the American Institute of Accountants *Statement on Auditing Procedure No. 23*. In general, the certified public accountant must refrain from expressing an opinion when he fails to follow "generally accepted auditing procedures" or when there are departures from the "generally accepted accounting principles."

Ordinarily, it is presumed that the requirements for presenting opinions or disclaimers for special problem reports have been established by *Statement No. 23*. Yet, as indicated earlier, the accounting principles referred to were designed for commercial corporate accounting. The exact requirements for preparing opinions or disclaimers become difficult to determine where procedures are used which might be quite acceptable and usual for municipalities, educational institutions, farming organizations, or other organizations that keep their records on a cash basis, but which would not be satisfactory for corporate accounting.

Opinions and Disclaimers

Where Cash Basis Is Used

It has been maintained by some accountants that an unqualified opinion can be rendered where cash basis accounting procedures are used. For the most part, though, the trend in thinking seems to be that either a qualified opinion or disclaimer must be prepared. This is based on the fact that the cash basis is not usually considered to conform with generally accepted accounting principles and that only with accrual accounting is there a complete and

fair presentation of all assets and liabilities.

In organizations where inventories are not involved—e.g., clubs and fraternities, professional firms, and organizations deriving income from rents, royalties, and dividends—the cash basis may be adequate. In such cases the results generally are substantially the same as they would be if the accrual basis were used, and an opinion, with a brief disclosure that the cash basis was used, would be satisfactory.

Even where there are inventories or significant receivables or payables there are those who maintain that the accountant could render an opinion, provided he clearly discloses the use of the cash basis and indicates the effect of the departure from accepted principles of accounting. However, such a qualification would seem to negative the opinion and make it necessary to render no opinion at all. Where material assets or liabilities are omitted it does not appear reasonable to state that there is a fair presentation in the financial statements.

Some of the major problems arise in connection with reports for farmers. The statement is made that the cash basis is generally used by farmers and that it is acceptable for tax purposes. Use for tax purposes to reflect taxable income is not necessarily a criterion for acceptable principles of accounting. Further, many inadequate procedures have been used in the past, but the trend has been to be forthright in audit reports and to present nothing which may mislead the reader or not present the data fairly. This trend should not be weakened or reversed. In developing standards, a distinction must be made between general use and general acceptability.

Other Disclosures Required

To maintain that a qualified opinion or a disclaimer must be used when reporting on accounts kept on a cash basis does not mean that statements and reports cannot be prepared. On the

contrary, farmers and others who keep their records on a cash basis need more and better accounting service. It is incumbent upon CPAs to render such service. However, a "watering-down" of standards will benefit no one. The greatest service that accountants can render for farmers as well as for the accounting profession is to make full disclosure of the use of the cash basis and the amount of the assets and liabilities which are omitted as a result. Perhaps, if that much work is done, it would be little more to convert the report to an accrual basis. If that is the case, so much the better.

Also, it may be difficult or impossible to evaluate the assets. Yet it would be a contradiction of terms to say that the data are presented fairly and then to say certain assets of an undetermined value have not been recorded. Clearly, a disclaimer is appropriate in such cases. The disclaimer does not destroy the value of the report. If anything, it increases its value by being more informative to third parties, if the reason for the disclaimer is explained. In addition, the accountant may deny an opinion as to the fairness of the presentation of financial condition and results of operations and yet give assurance of the accuracy of what is stated.

Under some circumstances disclosure to the effect that the financial data presented comprise a statement of cash receipts and disbursements would be appropriate. However, in most cases the tax basis departs from a strictly cash basis, and other disclosures would be necessary.

Opinions Relating to Proprietorship Financial Statements

The problem becomes even more complex when related to opinion reports for sole proprietors. The difficulties encountered when the proprietorship is on a cash basis are the same as those of other organizations on a cash basis. In addition, there are a number of special problems involved in proprietorships. In particular, these involve

the provision for salaries and income taxes of the proprietor. The same situation exists even if the proprietorship reports on an accrual basis.

Because of the legal relationship between the corporation and its employees, even if they are major stockholders, no problem exists either in practice or accounting theory with respect to the recording of salaries. In proprietorships, salaries of owners are rarely recorded. This means that the category "net income for the period" apparently has quite a different meaning for proprietorships as compared to corporations. It also raises a question as to the fair presentation of the operating results of proprietorships, if the concepts underlying corporate financial statements are used as the criteria. In many instances it may not be difficult to provide for proprietors' salaries. If an opinion is to be expressed, this probably should be done. In all cases where provision is not made for salaries, full disclosure of the nature of the "net income for the period" would seem to be necessary.

Certainly the provision for income taxes in the financial statements is a fundamental and accepted accounting procedure. In almost all cases failure to record income taxes would lead to the omission of a significant liability, and if an opinion is to be expressed, provision should be made for income taxes.

Where the business entity is only one of several in which the proprietor is engaged, or where his other financial interests are sufficiently large to make a provision for income tax as applied against the particular business under review meaningless or misleading, an allocation of the proprietor's total tax should be made. The report should also disclose the method used in making the allocation. In some instances it may be wiser to prepare a disclaimer and not to attempt to provide for income taxes on the statements of the proprietorship. In such circumstances, a statement in the report that no provision had been made

for the proprietor's liability for income taxes would be adequate disclosure, and would explain the reason for the disclaimer.

By their very nature proprietorships are small businesses. In small and medium-sized businesses the auditor usually prepares the financial statements. In many cases he also directs much of the bookkeeping of the company. The generally accepted auditing procedures which have been established for professional public accounting have dealt mainly with large businesses. In such large concerns the auditors do not have personal contact with the accounting records except in the review and examination of the records.

This raises the question whether the auditor may prepare an opinion where he keeps the books and prepares the statements. While there is much feeling to the contrary, it appears to be the consensus that keeping the books does not necessarily deny the independence of the accountant. He may be entitled to express an opinion if he has made a satisfactory audit and has satisfied himself as to the fairness of the data which are presented. Generally, there should be some disclosure in the report that the nature of the business made it necessary for the accountant to do more than "examine the balance sheet and related statements of income and surplus." It has been suggested that the proper statement for such a report would be "We have examined the financial records and prepared the balance sheet and related statements of income and surplus. . . ."¹

There is also another danger in reporting for sole proprietorships. Often personal assets as well as liabilities of the proprietor are commingled with the business assets. Sometimes this is done at the request of credit grantors who wish to take the proprietor's personal assets and liabilities into account in determining his credit rating. Obviously,

a proprietorship is not a "credit entity." From the standpoint of creditors the owner's personal assets and liabilities have little or no distinction from business assets and liabilities. Nonetheless, opinion reports should not be prepared where personal and business assets are commingled.

Trend in Converting to the Accrual Basis

The major obstacle in the preparation of unqualified opinions for the special-problem reports appears to be centered in the use of the cash basis. However, an analysis of the various organizations that traditionally used cash basis accounting procedures reveals a definite trend toward the use of the accrual basis.

For income tax purposes all businesses that have inventories are required to use the accrual basis. This means that most small businesses, even if their only objective is to maintain records for tax purposes, must either keep their records on an accrual basis or convert to the accrual basis in the computation of taxes. Even where the tax laws do not require the accrual basis, some small businesses and farming organizations have found it advantageous to convert to the accrual basis in preparing the statements asked for when they seek new sources of credit. Many professional firms, fraternal organizations, and charitable organizations have also found it necessary to accrue income and expenses in preparing their reports in order to be sure that the various assets and liabilities are properly disclosed.

The most significant indication of the trend is found in municipal accounting. In its 1951 statement, the National Committee on Governmental Accounting stated explicitly, "The use of the accrual basis in accounting for revenues and expenditures is recommended to

¹ Leo Herbert, "How to Prepare Working Papers and Reports Especially Suited to Audits of Small Business," *The Journal of Accountancy*, Vol. 93, No. 6 (June 1952), p. 701.

the extent applicable."² It was pointed out that such a basis makes possible a more accurate comparison of revenues and expenditures and also makes it possible to utilize standard costs and other cost accounting procedures.³ An examination of the recent reports of governmental units, educational institutions, and business proprietorships as compared with similar reports of ten to fifteen years ago gives clear evidence of the increased use of the accrual basis.

Disadvantages in Requiring Conversion or Reconciliation to the Accrual Basis

While there is undoubtedly a definite trend toward the accrual basis for financial reports, there are a number of instances where it would be impractical or impossible to maintain the records on such a basis.

One illustration is in the handling of growing crops in connection with the preparation of reports for farmers. Since farmers may report their income taxes on the cash basis without regard to inventories or growing crops, there is a reluctance to convert the records to the accrual basis for the preparation of financial reports or any other purpose. More important, because of the many hazards present in farming operations, there are some practical difficulties involved in properly valuing growing crops.

It is common practice in the preparation of farm financial statements to take up notes and contracts payable on equipment and depreciate the fixed assets, but to eliminate inventories and growing crops from consideration. Since such practices are consistently followed, it has been argued that it would be proper to state that the financial statements present fairly the financial position and results of the operation of the farm enterprise in accordance with the generally accepted principles of farm accounting. So far as the inven-

tories are concerned such a position is questionable. Because farmers get special treatment for income tax purposes does not mean that the principles underlying opinion reports should be modified. What if the tax law is changed! While there are difficulties in valuing farm inventories, many manufacturers and retailers have similar difficulties.

The situation is somewhat different for growing crops, however. The costs of sowing, cultivating and harvesting the crops can be used to value farm inventories. For growing crops, the initial costs of sowing and cultivating conceivably could be used, but the element of uncertainty has to be taken into consideration. To evaluate growing crops at more than their current realizable value may anticipate sales proceeds and overstate the assets. In most cases a general statement of the approximate acreage of principal crops may be more revealing than a rough approximation of the cost. Under the circumstances, an opinion qualified to the extent that no value had been given to the growing crops would appear to be the most appropriate solution.

A second illustration of the disadvantage of unequivocally requiring conversion or reconciliation to the accrual basis occurs in the case of depreciation on the fixed assets of municipalities. Due to the established procedures and the legal requirements in most governmental units, it would be almost impossible to require the accrual basis for depreciation of municipal fixed assets. The National Committee on Governmental Accounting has stated explicitly that "Depreciation on general municipal fixed assets should not be computed unless cash for replacement can legally be set aside."⁴

Another situation in which it would be disadvantageous to require the accrual basis is in connection with the recording of receivables for fund raising groups and for many fraternal or-

² National Committee on Governmental Accounting, *Municipal Accounting and Auditing*, No. 14 in a series of publications (Cushing-Malloy, Inc., Ann Arbor, Michigan, 1951), p. 2.

³ *Ibid.*, p. 10.

⁴ *Ibid.*, p. 2.

ganizations. While there is a legal claim which would ordinarily give rise to a receivable and an accrual of income, the possibility of pressing such a claim is so remote that the accrual basis actually may be misleading. Of course, past experience may indicate that a large proportion of such receivables will be collectible, and if an adequate reserve is set aside such an accrual may be reasonable.

Due to the fact that direct confirmation of such receivables is not customary and adequate verification of cash collections is most difficult, disclaimers are usually required for this type of report. If the audit procedures were satisfactory, however, and the receivables recorded, an unqualified opinion could be rendered. Or if there were adequate verification of all items except the receivables and adequate disclosures were made of the amount of the receivables and the estimated collections, a qualified opinion may be permissible.

Status of Accepted Principles of Accounting Re Special-Problem Reports

Most accountants would not state explicitly that there are different sets of accounting principles applicable to different types of organizations. Yet, those who argue that there are different rules applicable to governmental, educational, and cash basis financial statement reporting imply that there is more than one set of accounting principles. The difficulty is that there has not yet been established a set of criteria which may be applied to accounting for all types of enterprises or types of business ownership and all types of legal restrictions and control.

Whether such criteria can be established is a moot question. In government, for example, accrual accounting has a different purpose than in commercial accounting. In the latter its primary use is to aid in determining the amount of profit or loss plus giving

a more accurate statement of financial condition at the end of the period. In governmental accounting the amount of gain or loss is of little or no importance except for trust, working capital, and utility funds. In recording accruals of revenue and expenditure the objective of a government unit is merely to keep the fund activities within the legal pattern or the schedule laid out by the legislative body. Moreover, compliance with established legal requirements often makes it impossible for municipalities to use procedures generally accepted for commercial accounting. Also, established categories and definitions are not applicable since special or quite unusual terminology must be used.

As already indicated, fund accounting properly ignores some accruals and almost all depreciation. Since there is an authoritative body of rules and procedures set forth for governmental accounting, it may be maintained that it would be appropriate to render an opinion which states that the financial statements are presented "in accordance with generally accepted principles of governmental accounting." The same reasoning may be applied to the preparation of reports for educational institutions and similar organizations if the procedures are adequately established, even though they are not the same as those used in commercial accounting.

The status and general acceptability of the accounting literature in the special area is the basis for determining if the procedures are adequately established. If this were not so, it could be argued that reports prepared primarily and specifically for purposes of administrative control but which do not follow all of the specific requirements of an audit for third parties could carry an opinion which relates to "principles of accounting for administrative control." Similarly, reports prepared in connection with the preparation of income tax returns, which follow the requirements of the Director of Internal Revenue, could carry an opinion stating

that the presentation has been made in accordance with "generally accepted principles of accounting for tax purposes." Statements which satisfy the specific requirements of bankers or credit organizations might be presented as having been prepared in accordance with the accounting principles generally accepted by banks or credit organizations. These examples could be carried on indefinitely.

Dangers Involved

The point could be reached where you would have accepted principles for every type of business and conceivably, for each concern within an industry. If this point of view were to be accepted, it would lead to a complete reversal of the developments during the last fifty years. The emphasis has been upon the adoption of definite accounting principles and consistency in their application. It was not so many years ago that there was not even agreement as to whether a statement of accounting principles could be formulated, to say nothing of an agreement as to what such principles should be. It was only after considerable effort that the currently accepted accounting principles were distilled from the myriad of methods of presenting items on financial statements. While there is still much to be done to improve current concepts and procedures, real progress can be made only by developing concepts with broader rather than narrower applications.

The same danger of fragmentation exists for generally accepted auditing procedures. To allow auditors to deviate from established auditing standards for special groups would probably give rise to many more disadvantages than the advantages that could be gained. The proper procedure would be to continue to develop and standardize audit-

ing procedures, but to expand the emphasis beyond corporate business enterprises.

Nature of Accounting Principles

For purposes of terminology it might be well to distinguish between underlying principles and accounting rules which are variable applications of such principles.⁵ By their very nature, the principles must be standard and subject to little or no dispute. The rules derived from them will have value only to the extent that they reflect the principle involved.

The basic principle underlying all accounting and reporting is that there must be a fair presentation of the financial position and the results of the operations of the given enterprise, regardless of its character. It would not be proper to employ special rules for special purpose reports which do not conform to the basic principles relating to the fair and adequate presentation of the financial data.

Nature of Auditing Standards

Auditing standards have been defined as the "underlying principles of auditing which control the nature and extent of evidence to be obtained by means of auditing procedures."⁶ The distinction between auditing standards and auditing procedures is that "... the later relate to acts to be performed, whereas the former deal with measures of the quality of performance of those acts, and the objectives to be attained in the employment of the procedures undertaken."⁷ The particular procedures to be followed in any given case depend on the particular circumstances. In some instances the procedures called for may be more detailed than in other instances. Nonetheless, the general body of accepted procedures is fairly well standardized and recognized.

⁵ See Gilbert R. Byrne, "To What Extent Can the Practice of Accounting Be Reduced to Rules and Standards?" *The Journal of Accountancy*, Vol. 64, No. 5 (November, 1937), pp. 363 ff.

⁶ American Institute of Accountants, *Codification of Statements on Auditing Procedure* (1951), p. 9.

⁷ *Ibid.*, p. 10.

Of particular importance in the special problem reports is the auditing standard which states that "sufficient competent evidential matter . . . be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination."⁸

Often the procedures followed to obtain such evidential matter vary considerably. How far these variations may go depends upon the circumstances. However, the complete omission of some of the procedures may abrogate the standard. In the case of fund raising campaigns, for example, the generally accepted procedure requiring direct confirmation of receivables is often quite impractical. Yet this particular procedure has considerable authoritative background. Its omission would seem to affect the standard materially. Based on this reasoning, it may be said that auditing procedures must carry out the basic intent of the standard in order to be "generally acceptable."

Need for Concentration on Broad Basic Principles

The analysis up to this point makes it clearly evident that there is a real need for further development of broad basic principles of accounting and auditing which would be applicable to all types of organizations. This need is emphasized by the following statement made by the Executive Committee of the American Accounting Association:

Although seldom given express recognition, accounting concepts are embodied in a framework of underlying conditions and assumptions such as (a) a business entity with an income objective, (b) a continuity of operations as a going concern, (c) the accrual basis of accounting, (d) the need for periodic reporting, and (e) the preparation, from underlying data, of statements embodying the point of view of stockholders.⁹

Under the circumstances, it would seem that the future objective should

be the preparation of a set of concepts that would be applicable to the "special problem" entities that do not have an income objective or that are not based on the corporate form of ownership. Instead of attempting to vary basic principles for various segments of government and industry, the concentration should be on broad basic principles applicable to more than corporate business enterprise.

Recommendations for Report Writing Procedures

Upon reflection, most accountants will agree that there is already a wide area of basic uniformity in the presentation of financial statements. Governmental units have been adopting standard procedures of accrual accounting rapidly over the past years. While most farmers still use the cash basis, a number of them have found it advantageous to use accrual accounting. The trend seems to be in the right direction. It is recommended that accountants continue to encourage the use of the accrual basis, wherever possible. By so doing the standards of reporting for all types of organizations will be improved.

This does not mean that accounting records should not be kept on a cash basis or that special procedures should not be used on occasion. It merely emphasizes the fact that there should be an extremely judicious use of the cash basis or other special procedures.

In the case of municipalities, colleges, and similar organizations the opinion may properly refer to generally accepted principles of municipal accounting or college accounting. If this is done, however, it is recommended that disclosure be made of all variances from established methods, and also that adequate notation be made where the methods used are in agreement with

⁸ *Ibid.*, p. 10

⁹ American Accounting Association, *Accounting Concepts and Standards Underlying Corporate Financial Statements* (1948 Revision), footnote, p. 1.

The Special-Problem Report

standard procedures. Then there would be no question whether a strict cash basis, modified cash basis, or modified accrual basis were being used, and there would be no need to convert or reconcile the data to the accrual basis which would ordinarily be used by private commercial business.

In all cases, it is recommended that principles which are now generally accepted should be followed to the fullest extent possible. More important, though, there should be a continuing critical review of the basic principles. Progress in this field can be made only if there is a constant examination of what is being done to determine if the current procedures are adequate, or if there are better ways to accomplish the required objectives. Constant review and analysis, and change where necessary, is not incompatible with

wider acceptability of the principles.

In the special problems area, it is recommended that there be conformity, as far as possible, with the general principles which have been established. Even though these accounting and auditing principles were developed primarily for commercial corporate accounting, most of them are applicable for all types of accounting, auditing, and reporting. Finally, it is recommended that there be continued analysis of the special-problem reports. This critical analysis should be made by all persons responsible for preparing such reports as well as the professional accounting organizations. The changes required to solve the problems undoubtedly will come slowly, but they will probably have far reaching significance and should result in the improvement of all accounting reports.



Book Reviews

(Continued from page 370)

by excesses in the other direction, and more moderate action by the Commission is now required. Decisions with regard to disposition of Account 100.5 balances, reaccounting and transactions with associated companies are examples of this unduly harsh attitude. What is needed in each of these situations is a decision based on a study of the facts of each case rather than one which conforms to a handy, previously determined rule. By this more temperate attitude, the Commission would do much to remove the objections to its accounting policies."

Professor Davidson's thorough study of this subject with suggestions and conclusions should be of interest to regulated companies and to accountants, lawyers and others serving such companies. It should also be useful to teachers and students in the fields of economics, finance and accounting.

DUNCAN G. MACKENZIE

New York, N. Y.

C.P.A. Law Manual

(Questions and Answers)

By Andrew J. Coppola and Harry Katz.
OCEANA PUBLICATIONS, New York, N. Y.,
1953. Pages: 122 (paper bound); \$2.00.

This valuable little manual contains the answers to about 600 questions drawn from the A.I.A. uniform examinations in Commercial Law held during the five-year period from May, 1948, to November, 1952. The questions have been classified by subject in order to facilitate study of each individual topic. In addition, an actual examination (November, 1952) is contained in the Appendix as a specimen of the form and content of the examination.

Although concise, the manual is quite complete. It has been prepared by two practicing attorneys, who have also taught the subject for some time. It should be a valuable aid to all C.P.A. examination candidates.

Short-Term Forecasting of Cash Receipts

By LESTER AGELOFF, C.P.A.

Three methods of short-run forecasting of cash receipts are discussed in this article: (1) the control-chart method, (2) correlation analysis, and (3) numerical analysis. The author concludes that the first-named method is limited in application and does not yield precise information; and that the second technique has the danger of projecting past mathematical trends into the future, which danger increases as the period upon which the analysis is based recedes further into the past. He favors the third method as one which is always based on up-to-date data and developments.

AN accurate forecast of cash requirements is a very important tool in management planning. Its proper application enables a fuller use of working capital and more efficient financing. The long-term cash forecast is made as part of the over-all budgeting operation, and sets forth the cash requirements for a period of a year or more in a rather general way. While this is adequate for long-term planning, the everyday cash needs of the business require a more accurate analysis. Therefore, a continuing short-term forecast is employed, usually covering a period of from one to three months.

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He received his B.B.A. in Accountancy and his M.B.A. in Statistics from The City College of New York. At the present time he is a doctoral candidate at the Graduate School of Business Administration at New York University, preparing a dissertation on the applications of statistics in auditing.

He is a member of Beta Gamma Sigma and the American Statistical Association.

This forecast consists of three elements:

1. a statement of cash requirements for the period;
2. a forecast of sales for the period; and
3. an estimate of the collection period relating to these sales.

The first of these, the statement of cash requirements, is the easiest to prepare. Enough information is usually available as to fixed charges, purchase commitments, bills maturing for payment, payrolls, and other expenses, to make possible a very accurate assessment of short-term cash needs.

The short-term forecast of sales is made by analyzing the unfilled orders on file, and comparing them with production schedules to arrive at probable dates of shipment. It is generally unnecessary to predict what orders will be received (as would be the case with long-term sales forecasts) since the unfilled orders in the house are usually sufficient for estimating sales for the one to three month period of the forecast.

The third problem, the estimate of the collection period pertaining to these sales, is the subject of this paper. We will discuss some methods of analyzing cash collections from accounts receivable, to form the basis of a forecast of the liquidation of future receivables.

Short-Term Forecasting of Cash Receipts

The Control-Chart Technique

The simplest method is to compute the monthly ratio of receivables to sales, based on the general ledger accounts, and accumulate this data in chart or tabular form, to arrive at an average

collection experience. Table I, following, is a summary of the collection experience of a small manufacturing company, based on actual data. Figure I represents the same data, charted as a time series.

TABLE I:

ABC CO.
ANALYSIS OF COLLECTION EXPERIENCE
Years 1949-1950

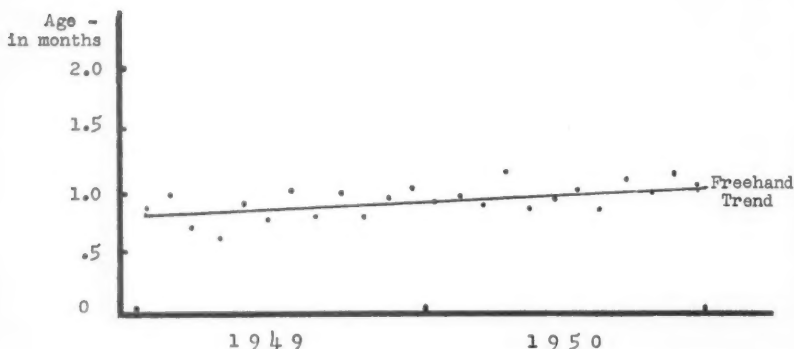
Month	Accts. Rec. Balances, End of Month (in \$1,000)	Monthly Sales (in \$1,000)	Ratio of Accts. Rec. Balances to Monthly Sales (age—in months)
J	53.0	61.1	.868
F	62.8	63.7	.986
M	55.6	83.2	.668
A	51.9	86.6	.599
M	61.5	72.9	.844
J	51.0	66.9	.762
J	44.5	44.2	1.007
A	49.8	65.5	.760
S	53.6	56.1	.956
O	70.9	93.9	.755
N	83.5	90.0	.928
D	71.7	70.3	1.018
J	49.1	54.7	.898
F	58.9	63.5	.925
M	67.5	77.1	.875
A	60.7	52.7	1.150
M	66.7	79.5	.838
J	60.3	65.3	.923
J	70.8	74.3	.952
A	111.5	142.4	.784
S	100.0	91.9	1.085
O	120.9	127.2	.949
N	114.1	103.3	1.102
D	69.6	72.4	.963

NOTE: The ABC Company sells on ten-day terms, so that the receivables at the end of any month consist substantially of the sales made during the month. Proper application of this method requires that sales be compared with their corresponding receivables.

It is desirable to plot the data on a chart to ascertain whether any underlying trends are affecting the average collection period. In this particular case, a slight upward trend may be seen, indicating a gradual slowing of collections. The forecaster of future collections would make note of this

trend in preparing his estimate. When several years' data have been accumulated, it might be possible to discern a seasonal pattern in the fluctuations of the age of receivables about the trend-line. In that case, the forecast can be further refined to take into account the seasonal factors. In the present exam-

Figure I: ABC Company, Age of Accounts Receivable, Monthly Data, 1949-1950 (Data of Table I):



ple, there is not enough information available for this purpose. The forecaster, making note of the trend, might estimate collections to require 1.02 months in January, 1.03 months in February, and 1.04 months in March. Or he might decide that this trend will not be continued, basing this decision on his knowledge of market conditions. In that case, he will estimate the future collection experience to be somewhat less than that indicated by the trendline.

This type of chart closely resembles the control charts employed in statistical quality control. However, no statistical control limits have been computed, such as are usually employed on control charts to determine whether or not a deviation from the average could have been due to chance. There is a serious question as to the validity of such statistical measures in this particular case, because of the interdependence of the various months' data. Notwithstanding the lack of an "objective" statistical criterion to evaluate the highs and lows of the data, it is nevertheless possible to run one's eye over the chart and pick out those months that materially differ from the average. There can often be found some particular cause for the extreme variations. In the example given, it was found that the months of March and April, 1949,

showed an unusually low average age of receivables because of the collection in those months of two large government accounts receivable which had been open for some time. On the other hand, the month of April, 1950, appeared to be unusually bad until it was discovered that some substantial foreign shipments had been made in that month, on which collections had been much slower. Thus, this type of chart may be used to evaluate constantly the efficiency of collections, at the same time that it is yielding information for the forecast of cash receipts.

One word of caution about using this type of analysis: the receivables should be matched against the sales to which they pertain. In the example given, the company sold on 10-day terms, so that the bulk of its sales were collected in the month in which sold. If thirty-day terms were employed, it would have been necessary to lag the collections one month before comparison. Also, if the total accounts receivable balances are greater than the average month's sales, they should be related to a two-month sales figure, in order to cut down distortions due to fluctuation in monthly sales. It can be easily seen that the use of this method is limited to certain cases where workable conditions prevail.

The method is crude, and yields only

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an approximate "aging" of receivables at best, because it is based on general ledger aggregates and not on a detailed analysis of the accounts. However, it has worked with sufficient accuracy for control and forecasting purposes, in a business situation where there were 10-day terms of sale and the collection experience was very good.

Correlation Analysis

An analysis of collection experience may be made by means of a correlation

analysis, where collections are plotted against sales in a scatter diagram, and regression lines are fitted by mathematical or freehand methods.

In one particular case (not illustrated here) a least-squares regression was fitted to the data, with the cash receipts as the dependent variable, and the prior month's sales and opening balances of receivables as the independent variables. An estimating equation was obtained in the following form (data illustrative only):

$$Y_c = 40.5 + .75 X_1 + .425 X_2, \text{ in thousands of dollars}$$

where Y_c was the computed estimate of collections,

X_1 was the prior month's sales,

X_2 was the open balance of Accounts Receivable, first of prior month.

According to the equation, March collections will equal 75% of February sales plus 42½% of the balance of receivables on February 1st, plus \$40,500. When the collections "forecasted" by this relationship were computed for the 24-month period from which it was derived, and then compared with actual collections for the period, it was found that the average deviation of "forecast" from actual was in the neighborhood of 5%, with no deviation over 10%.

Despite the indicated accuracy, this relationship was never used for forecasting purposes for a very good reason: the danger of extrapolating a past relationship into the future. As the months pass, the period upon which the forecasting equation is based becomes more and more remote, and the validity of the relationship becomes

weaker and weaker as external economic factors and internal policies change. This could be corrected by recomputing a new equation as each month's information becomes available. However, this is a time-consuming task. A simpler method of analysis was developed, and its use made unnecessary the mathematical computations described above.

Numerical Analysis

This procedure is based on a monthly aging of the detailed accounts receivable. The company where the analysis was used made it a monthly practice to age the past-due items in its unpaid invoice file. Thus, the information was already available for analysis. The results of this aging would be as follows (all data hypothetical):

Aging of Past-Due Accts. Rec., May 31, 1951

Up to 20 days past due.....	\$110,000(a)
21 to 50 days past due.....	22,000(b)
51 to 80 days past due.....	10,000(c)
81 to 110 days past due.....	2,000(d)
Total Past Due	<u>\$144,000</u>

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The results of the aging are posted monthly to a summary sheet, where past-due balances are related to the months in which the sales were made.

A summary sheet for an entire year is shown in Table II, with the entry of the four items listed above keyed off with letters.

TABLE II:

XYZ CO. SUMMARY OF PAST-DUE BALANCES (Illustrative Data Only)

Due Date	Sales in Period Preceding Due Date (\$1000)	1951 Past-Due Balances							
		20 days past due		50 days p.d.		80 days p.d.		110 days p.d.	
		Amt. (\$1000)	% of Sales	Amt. (\$1000)	%	Amt. (\$1000)	%	Amt. (\$1000)	%
2/10/51	350	87	24.8	34	9.7	8	2.3	(d)2	.6
3/10	475	129	27.0	56	11.7	(c)10	2.1	1	.2
4/10	220	50	22.7	(b)22	10.0	6	2.7	1	.5
5/10	460	(a)110	23.9	36	7.8	2	.4	0	—
6/10	585	145	24.8	51	8.7	5	.9	2	.3
7/10	320	70	21.9	36	11.2	8	2.5	1	.3
8/10	400	95	23.7	35	8.7	10	2.5	2	.5
9/10	512	144	28.1	64	12.5	15	2.9	3	.6
10/10	185	46	24.9	18	9.7	4	2.2	2	1.1
11/10	315	75	28.8	28	8.9	5	1.6	2	.6
12/10	508	122	24.0	47	9.3	12	2.4	1	.2
1/10/52	270	55	20.3	22	8.2	1	.4	0	—

An analysis of collections is prepared, based on the tabulations of past-due balances. This is computed by subtracting each month's closing balance from its opening balance to arrive at collections for the period. The results of such an analysis are given in Table III.

(Numerical example: the \$350,000 sales due Feb. 10 had \$87,000, or 24.8%, outstanding on Feb. 29, thus \$263,000, or 75.2%, were collected in February; \$34,000 or 9.7% were outstanding on March 31, thus \$53,000, or 15.1% were collected during March.)

TABLE III:

XYZ CO. ANALYSIS OF COLLECTIONS 1951

Month	Sales (in \$1000)	Month due		Collections							
		Amt. (in \$1,000)	%	2nd Month Amt.	%	3rd Month Amt.	%	4th Month Amt.	%	5th Month Amt.	%
Jan.	350	263	75.2	53	15.1	26	7.4	6	1.7	2	.6
Feb.	475	346	73.0	73	15.3	46	9.6	9	1.9	1	.2
Mar.	220	170	77.3	28	12.7	16	7.3	5	2.2	1	.5
Apr.	460	350	76.1	74	16.1	34	7.4	2	.4	0	—
May	585	440	75.2	94	16.1	46	7.8	2	.6	2	.3
June	320	250	78.1	34	10.7	28	8.7	7	2.2	1	.3
July	400	305	76.3	60	15.0	25	6.2	8	2.0	2	.5
Aug.	512	368	71.9	80	15.6	49	9.6	12	2.3	3	.6
Sept.	185	139	75.1	28	15.2	14	7.5	2	1.1	2	1.1
Oct.	315	240	76.2	47	14.9	23	7.3	3	1.0	2	.6
Nov.	508	386	76.0	75	14.7	35	6.9	11	2.2	1	.2
Dec.	270	215	79.7	33	12.1	21	7.8	1	.4	0	—

Short-Term Forecasting of Cash Receipts

The final step is the preparation of a cumulative collection history for each month's sales. This is a summary, in

percentage form only. It is illustrated by Table IV, below:

TABLE IV:

XYZ CO. CUMULATIVE COLLECTIONS as percents of sales 1951

Month of Sale	in 1 month	in 2 months	Percents Collected in 3 months	in 4 months	in 5 months
Jan.	75.2	90.3	97.7	99.4	100
Feb.	73.0	88.3	97.9	99.8	100
Mar.	77.3	90.0	97.3	99.5	100
Apr.	76.1	92.2	99.6	100.	100
May	75.2	91.3	99.1	99.7	100
June	78.1	88.8	97.5	99.7	100
July	76.3	91.3	97.5	99.5	100
Aug.	71.9	87.5	97.1	99.4	100
Sept.	75.1	90.3	97.8	98.9	100
Oct.	76.2	91.1	98.4	99.4	100
Nov.	76.0	90.7	97.6	99.8	100
Dec.	79.7	91.8	99.6	100.	100

With the preparation of the third table, all the pertinent information is available to the forecaster. It may seem to be a difficult task to prepare three such tables, but if they are kept current as the new information becomes available, it is only a matter of a few minutes' work each month. The data illustrated above have been set up as an illustration, and have no resemblance to actual data in the company in which this method was employed, either as to the magnitudes or as to the monthly collection experience. However, the numbers used here were chosen to illustrate several points which became evident after this method was in use for a short time:

- It became quite plain that an average percent could be established for each month's collections.
- It also became fairly clear that cumulative collection percents

(Table IV) were subject to less fluctuation than individual month's percents (Table III), with the fluctuations decreasing as more months were included. Thus, it was found that if the first month's collections were not up to expectations, the second month's collections very likely would make up the deficiency. This information was of great value for forecasting purposes.

- It was also possible to detect trends in collections and allow for them in the forecast.

With the above data available to him, the forecaster can use one of two methods to forecast cash receipts for the coming month. For illustration, suppose that a forecast is desired for the month of June, 1952. On June 1, the following information is available:

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STATUS OF ACCOUNTS RECEIVABLE, MAY 31, 1952

	Total Sales	Collected to date	Balances
Due June 10	\$360,000	-0-	\$360,000 by subtraction
Due May 10	380,000	\$295,000	85,000 data from aging
Due Apr. 10	190,000	184,000	16,000 data from aging
Due Mar. 10	210,000	204,000	6,000 data from aging
Due Feb. 10	260,000	259,000	1,000 data from aging
Total Balances, May 31			\$468,000 from General Ledger

The first of the two methods uses the account prior collections and any trends average collection experience for each which the forecaster may have seen: age classification, modified to take into

COMPUTATION OF CASH FORECAST, JUNE 1, 1952

(in thousands of dollars)

Due Date	Sales for Period	Expected Collections to End of Month (%)	Expected Collections to E.O.M. (Amount)	Actual Collections to Date (Amount)	Difference = Expected Collections This Month
6/10	360	76%	272	-0-	272
5/10	380	91	346	295	51
4/10	190	98	186	184	2
3/10	210	99½	209	204	5
2/10	260	100	260	259	1

Expected collections (before discount) 331

The alternative method consists of the use of an average collection experience for past-due items, and an average experience for current items. Thus two computations take the place of the five above, but the average collection experience for past-due items must be derived beforehand. This may be derived as in Table V, below:

TABLE V:

XYZ CO.

COMPUTATION OF COLLECTION EXPERIENCE

Past Due Items

Month 1952	(1) Past-due 1st of Mo. (in \$1000)	(2) Collected during Mo. (1-3)	(3) Old Past Due End of Mo. (5-4)	(4) Added to Past-Dues this Mo.	(5) Total Past-Due E.O.M.	(6) Percent Collected during Mo. (2) ÷ (1)
May	144	101	43	145	188	70.1%
June	188	134	54	70	124	71.3
July	124	83	41	95	136	66.9
Aug.	136	91	45	144	189	66.8
Sept.	189	114	75	46	121	60.4
Oct.	121	86	35	75	110	71.1

Columns (1), (4), and (5) are derived from Table II; the other three are the results of the indicated computations. According to this analysis, it was

Short-Term Forecasting of Cash Receipts

found that collections of past-due balances averaged 67.7% of the amounts outstanding each month. Then the cash forecast is computed as follows:

COMPUTATION OF CASH FORECAST, JUNE 1, 1952

	Amount —in \$1000	Expected Collections —in %	Expected Collections —in Dollars
not due	360	76 %	\$272,000
past due	108	67.7 %	73,000
Total—before discount			\$345,000

It will be seen that two different results are obtained by using the two different methods, although they are not at great variance with each other. Of the two methods, the former is the more exact, the latter is the easier to compute (but requires an additional analysis).

Conclusions

Three methods of short-run forecasting of cash receipts have been discussed. The control-chart method is useful as an analytical tool, but its ap-

plications are limited and it does not yield precise information. Correlation analysis may be employed, but there is a danger in projecting past mathematical trends into the future. This danger increases as the period upon which the analysis is based recedes further into the past. The most satisfactory method is a system of numerical analysis, based upon a monthly aging of past-due accounts. This analysis is constantly brought up-to-date, and recent developments can be taken into consideration when making next month's forecast.



New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Statute of Limitations— Income Tax

The State Tax Commission has three years from the date a return is due within which to audit the return and determine the tax. If a taxpayer has omitted from his return an amount "which is in excess of 25%" of gross income or capital gain, the limitation period is five years from the due date of the return.

In 1949, the legislature amended Section 373 of the law¹ and provided that there shall be no limitation of time to determine or collect the tax if no return is filed or a fraudulent return is filed or "if a taxpayer shall fail to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States. . . ."

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Suppose a final determination is made in 1952 by the Commissioner covering the taxable years 1943 and 1944, must the taxpayer notify the Tax Commission of these changes? To what extent if any does the statute of limitations prevent the Tax Commission from assessing any tax based upon the federal changes made for the years 1943 and 1944, assuming there is no element of fraud.

Section 373 and Article 571(a) of the Regulations provide that the Tax Commission is not authorized to make any additional assessment when the statute of limitation has expired by July 1, 1949. That would prevent the Tax Commission from assessing any tax for the year 1943 under the three-year limitation or the five-year limitation. It would also prevent the Tax Commission from assessing any tax for the year 1944 under the three-year limitation and, in our opinion, under the five-year limitation as well.

The law (Section 367) requires a taxpayer to notify the Commission within 90 days of a federal change based upon a final determination. If the statute of limitations has already run when the final determination has been made, the Tax Commission, in our opinion, is without power to revive the period of limitation. There is a provision in the law and regulations² giving the Tax Commission the power to recompute the tax within one year after notification of a federal change or at any time if no notification is given. The latter provision must refer only to those cases where the final determination has been made within the three- or five-year

¹ L. 1949, Chapter 93, section 2—effective July 1, 1949.

² Section 373.4 and Article 571(a).

period when the Tax Commission has the power to act.

Change of Residence

A resident is taxable on his income from all sources. A non-resident is taxable only on income from sources within the state. If an individual changes his residence during the year from a non-resident to a resident, or the reverse, taxable income is determined under special provisions in the law.

First, two returns are required, one covering the period of residence and another the period of non-residence. The personal exemption and dependency credit are prorated on the basis of the number of months covered by each return. The resident return will show income from all sources, while the non-resident return will show only income from New York sources.

For the period prior to the change in residence, income must be reported on the accrual basis even though the taxpayer is reporting on a cash basis. This provision in the law prevents a resident who becomes a non-resident during the year from avoiding the payment of a tax on income earned while a resident, but not realized in cash until he is a non-resident. This provision would be applicable equally to the non-resident who has earned income while a non-resident which he does not realize until he becomes a resident.

Deductions must be itemized on returns involving a change of residence. The flat 10% deduction up to \$500 may not be used where a return is filed for a period of less than twelve months.

Section 367(a) provides that the total tax due for the entire year on both returns may not be less than the tax that would be payable if the total net income and net capital gain were included in a single return. That means that the net income shown on each return must be combined in computing

the tax. A net loss attributable to either period would not be available as an offset to income for the other period.

Stock Dividends—Personal Property Law and Tax Law

A recent case³ highlights the treatment of stock dividends under the Personal Property Law. Section 17 (e) of that law provides that a stock dividend is considered wholly principal unless a will provides otherwise. In this case a will provided that all stock or extraordinary cash dividends shall be considered income. The trustees owned 1,500 shares of Gulf Oil Corporation. The directors of the corporation paid a 100% stock dividend and transferred an amount representing the par value of the new stock, partly from earned surplus and partly from capital surplus to capital. The court was asked to decide that the portion charged to capital surplus should be considered principal. Under the terms of the will the entire stock dividend was considered as income.

The tax aspect is of course determined by the Internal Revenue Code. As a true stock dividend it will not be taxable even though it is considered as income under the Personal Property Law. The term income is used here to designate the beneficiary entitled to income. Whether that income when received by the beneficiary is taxable or not is determined by the Tax Law.

Income of a Decedent in Year of Death

Section 358, sub. 1, provides two methods of treating income of a decedent accrued up to the date of death. It may be reported in the final return of the decedent or the executor at his option may include it in the income of the estate if he acquires the right to receive it. If any other taxpayer acquires the right to receive it by rea-

³ *Estate of Alvah K. Lawrie*, Surrogate's Court, New York County, N.Y.L.J., February 9, 1953, Page 449.

son of the death of the decedent, such taxpayer may agree to include it in his return when received by him. If the executor transfers the right to receive such income he must agree to include the fair market value of this right to the income plus any consideration received in excess of the fair market value in a return for the estate in the year of transfer.

The alternative treatment is optional and is further conditioned on the filing of a bond with the Tax Commission securing the return of such income by the estate or other taxpayer.

The Attorney General was recently⁴ asked to rule on whether the Tax Commission could permit an executor to exclude such income from the final return of a decedent and file such a bond after the expiration of the statutory period of limitations for the filing of an application for revision of a return that had been filed for the decedent for the year of his death.

The recipients of the income had also reported the income when received in subsequent periods.

The Attorney General ruled that there was no basis in the statute for permitting the filing of a bond after the decedent's return had become final. The Regulations (Article 542) require the filing of the bond at the time the return is filed. Nevertheless, the Attorney General added, the return is not final until the time granted by the statute for seeking revision has expired, so that the bond might have been filed at any time until then. In fact if such accrued items had not been included in the return filed and the Tax Commission had recomputed the tax on that ground, the executor could have applied for a revision within one year after the recomputation.

In the opinion the Attorney General goes into a history of this provision under the federal law and the state law. It should be noted that under the

Internal Revenue Code such accrued income is not taxable in the decedent's final return but is included in the income of the estate or the beneficiary receiving it. The state law is different in that it provides two methods and was so set up to furnish some relief from the hardship of accruing in one year income that might be received over a longer period of time. At the same time the law tried to protect the state against escape from taxation of such items.

Under the circumstances, if the recipients of the income have mistakenly reported it for taxation, they should file claims for revision of their returns.

Corporate Distributions Chargeable to Surplus Arising Out of an Appreciation in Value of Assets

The Attorney General, in an opinion to the State Tax Commission⁵, holds that a cash distribution to stockholders is a taxable dividend fully taxable under the income tax law, even though the surplus to which the distribution is charged results from a revaluation of real property. In the facts submitted to the Attorney General the funds used for the distribution were provided as a result of financing the construction of buildings through federal agencies upon such terms that the mortgages far exceeded the cost of the real property. The only surplus of the corporation resulted from an appreciation in the value of the realty.

Section 350(8) defines a dividend as any distribution by a corporation out of its earnings or profits. Clearly the distribution referred to does not come within this provision of the law as commonly understood by lawyers or accountants. The attorney general cites the case of *Randall v. Bailey*⁶ which held that the unrealized appreciation in value of fixed assets may be taken into consideration in determining whether

⁴ February 24, 1953.

⁵ March 13, 1953.

⁶ 288 N. Y. 280.

a corporate surplus exists from which a cash distribution may be made to stockholders. But the existence of a surplus does not mean that the corporation has any earnings or profits. The legality of the distribution as a "dividend" does not necessarily mean that what the stockholders receive are earnings or profits. The attorney general also cites the case of *People ex rel. Wedgewood Realty Co. v. Lynch*⁷ as decisive. But the issue was quite different in that case. Under Section 182 of Article 9, a real estate corporation is itself subject to a tax of 2% on any distribution out of any surplus. That provision does not purport to characterize the nature of the distribution in the hands of the stockholders, nor the extent if any to which it is taxable to stockholders.

A distribution not out of realized earnings or profits is clearly a return of capital. It is like a partial liquidation which may result in a capital gain. No sale or exchange is necessary in this type of transaction to bring it within the capital gain provisions of the law. Article 66 of the Regulations clearly states that any distribution not out of earnings and profits is to be treated as a return of capital.

The opinion runs counter to established principles of sound accounting and business practice. It would appear to be legally unsound and if acted upon by the Tax Commission will undoubtedly be contested by taxpayers.

Sale of Residence

Governor Dewey signed a bill giving relief to taxpayers who sell a residence at a gain. The new law follows generally the provisions of the Internal Revenue Code. The principal provision recognizes a gain on such a sale only to the extent that the selling price of the residence exceeds the cost of purchasing a new residence within a period six months prior to the sale and six months after the sale.

An exchange of the residence for other property is considered as a sale under this provision. So is the destruction or seizure of property followed by the acquisition of another residence. Stock held in a cooperative apartment is likewise within this provision.

The non-recognition of gain affects the basis of the new residence in that the cost of the new residence is decreased by the amount of the gain not recognized.

Under the new provisions, the Tax Commission is given the power to recompute the tax within three years from the date the taxpayer notifies the Tax Commission of the purchase and cost of a new residence which he claims results in non-recognition of gain. The law is effective as to sales made on or after January 1, 1952.

Exemption of Death Benefits From Income

Like the provision in the Internal Revenue Code, New York now exempts from tax payments made to the beneficiaries of an employee by reason of the death of such employee. The aggregate amount so exempt is limited to a total of \$5,000 for all the beneficiaries of the employee under a contract with any one employer. This law is effective as of January 1, 1952. The law speaks of payments made under a contract and the question will arise, as it has under the federal law, whether any voluntary payment will qualify or whether there must be a written contract. Under the federal statute, the contract may be either (1) a written agreement between the employer and employee which is not revoked before the employee's death, or (2) an established plan (or program having the effect of a plan) of the employer making provision for death payments in the case of employees generally or for a class or classes of employees. In the second case, the plan must have the effect of an enforceable contract. The

⁷ 262 N. Y. 202.

payments must be made to beneficiaries named in the contract. The exemption does not apply to payments made to a survivor or estate of a deceased employee, nor if made under a plan or contract primarily intended to provide benefits for the employee himself, as where the payments would have been made to him if he had lived. There can be more than one exemption of \$5,000, since there is a separate exclusion for payments made by each different employer.

Resident Trusts—Non-Resident Beneficiaries

A resident trust has distributable income of \$13,500 for the year 1952. On income taxable to the trust itself it had a small net loss resulting from the sale of securities. All but \$480 was distributable to beneficiaries residing in Connecticut and California. The trust income consisted of interest and dividends from securities, rent from real estate located outside New York and royalties and leases of lands in Texas. To what extent if any is the trust income taxable?

The New York law draws a distinction between a resident trust and a non-resident trust. Section 350 of the Law and Article 243 of the Regulations define a resident trust as one created by a person domiciled in New York at the time of the creation of the trust or one created by will of a deceased person who at the time of his death was domiciled in New York.

A trust is a taxable entity and generally the resident trust is taxable on all income from all sources. One important exception is that income properly paid or credited to any beneficiary during the taxable year is a deduction in computing the net income of the trust (Section 365.4) (Article 242(e)). That means that a non-resident beneficiary, like any non-resident, would not be subject to tax on the distributable income unless the income was derived from New York sources. In the instant case since the trust has no in-

come from real estate in New York or a business in New York, the non-resident beneficiaries would not be subject to any tax in New York. The New York beneficiary would be subject to tax on his distributable share of \$480.

Resident Trust—Requirement for Filing a Return

A collateral question in the above situation is whether the fiduciary is required to file any return, since the net income taxable to the fiduciary (Form 205—Line 20b) is less than \$1,000. Article 246.2 of the Regulations provides that the fiduciary of every trust whether or not taxable as an entity must make a return on Form 205 if any beneficiary receives a distributable share of taxable income of \$1,000 or over during the year. In the instructions accompanying the return, Form 205 is referred to as an information return and is required even in the case of a non-resident trust.

The Regulations do not limit the information required to resident beneficiaries. In fact, if there is a non-resident beneficiary the fiduciary is required to file a schedule of apportionment on Form 205-a showing income from New York sources.

It is true that the law speaks of the distributive shares of beneficiaries as deductions from gross income. Essentially it should not be so considered. On Form 205 amounts distributable to beneficiaries are deducted from the balance of net income determined after subtracting the usual deductions from gross income in order to arrive at any net income taxable to the fiduciary. In this respect the trust set up is like a partnership, the net income of which is taxable to the individual partners. In the case of the trust the net income (Line 20) is taxable to several taxpayers, the beneficiaries and the estate itself.

In our opinion if the balance of income (Line 20) is \$1,000 or more a return is required. Furthermore a return is required if gross income and

capital gain is \$5,000. This is a fair requirement since the Tax Commission should be apprised of the existence of trusts that are in receipt of income and be in a position to determine for itself whether any income should or should not be subject to tax.

Apportionment of Income

Accounting firms that do business in several states have an allocation problem. Consider the case of a partnership that includes some non-resident partners. The non-resident partners are subject to tax on income from New York sources and this will be determined by allocating to New York a proportion of the entire partnership income.

Section 360.a, of the law provides that the proper apportionment shall be determined under regulations prescribed by the Tax Commission. Article 457 permits an allocation "on a fair and equitable basis in accordance with approved methods of accounting." The Regulation further provides that "if the books of the taxpayer are so kept as regularly to disclose the proportion of his business income, which is earned from sources within the state, the return of the taxpayer shall disclose both the total income, and the part apportioned to the state of New York, and the basis upon which such apportionment is made. If such basis is approved by the tax commission, the return will be accepted."

In allocating income on the basis of approved methods of accounting it is proper to consider the item of partner's salaries, and this is done by charging against income a fair and reasonable amount for any resident partner actively associated with a particular office. The charge is made merely for the purpose of determining an allocation and is one of the factors that properly should be taken into account. It is similar to the item of executives' salaries under the allocation formula in Article 9A. In the payroll factor execu-

tives' salaries are eliminated for the reason that general executive officers are not restricted in their duties or services to any particular place. However if the duties or services of an executive officer are restricted to territory either within or without the state, such officer is not a general executive officer and his salary would enter into the payroll factor (Article 414.2).

For purposes of allocation the Tax Commission must consider a partnership as an entity. Under the Unincorporated Business Tax, not only is a partnership an entity and taxable as such, but in computing net income subject to tax, the law provides a deduction for salaries on account of the personal service of a member of a partnership subject to certain maximum limitations.

The provision for partners' salaries in determining an allocation of income within and without the state does not of course mean that the salary becomes a deduction from gross income in determining the taxable income of the partner. For that purpose the salary is part of the partner's distributable share of the income from the partnership.

Any apportionment made in accordance with approved methods of accounting must receive the approval of the Tax Commission before the return is accepted. In our opinion the Tax Commission would approve an allocation that takes into account a fair and reasonable salary for a partner whose services are restricted to any specific state.

Franchise Tax—Exemption

For many years a New York corporation engaged in ocean commerce between the United States and foreign ports was exempt from any franchise tax. Originally this exemption was to expire on December 31, 1952. The 1952 Legislature extended the exemption to December 31, 1953. The 1953 Legislature apparently deemed it desirable to extend further this exemption from tax to March 31, 1954.⁸

⁸ L. 1953, C. 614, effective April 9, 1953.

Unincorporated Business Tax— Salesmen

Any trade, business or occupation conducted by an individual is generally subject to this tax. The law was not intended to cover employees, such as salesmen. In recent years the Tax Commission has asserted the tax against salesmen employed by several firms on the theory that they were conducting a business as independent contractors.

The 1953 Legislature⁹ has amended Section 386 of Article 16A and specifically provides that "A person shall not be deemed to be engaged in an unincorporated business solely because of selling goods, wares and merchandise for more than one person, firm or corporation unless he maintains an office or employs one or more assistants or otherwise regularly carries on a business." This provision is applicable to returns for any year commencing on or after January 1, 1953. Regulations will probably give some content as to what is meant by a business otherwise regularly carried on. It is reasonable to assume that a salesman who "carries several lines" now will not be subject to the Unincorporated Business tax if he works alone and has no office of his own.

New York City General Business and Financial Tax

Section 24(a) of Article 2B of the General City Law taxes the gross receipts of all business or professional activity. The tax rate is $\frac{1}{10}$ of 1%. The rate is reduced to $\frac{1}{10}$ of 1% if the taxpayer is a dealer in merchandise, and the difference between the cost

of goods sold and the sales price is in the nature of a commission and in addition amounts to more than 3% but not more than 5%.

A person carrying on a financial business is taxed at the rate of $\frac{1}{10}$ of 1% of gross income instead of gross receipts. The 1953 Legislature¹⁰ added a provision to the law reducing the tax rate to $\frac{2}{10}$ of 1% for investment companies registered with the Securities Exchange Commission or investment trusts forming part of such investment companies. The new provision also gives the benefit of the reduction to any investment companies subject to Article 12 of the state banking law. Since the reduced rate is not effective until July 1, 1953, the returns due by May 15, 1953, will be at the increased rate of $\frac{1}{10}$ of 1%. The new rates will first be applicable on returns due May 15, 1954.

The definition of gross income also has been amended for all taxpayers subject to the business and financial tax. Gross income may exclude losses from transactions in securities up to the amount of gains from such transactions. This too goes into effect on July 1, 1953, so that it will not be applicable to returns filed by May 15, 1953.

New York City Gross Receipts Tax Returns

The 1953 legislature passed a bill, which has been signed by the Governor, making the general business tax returns due May 15 instead of June 15. The law went into effect on March 24, 1953, and is applicable to 1953 returns and returns for subsequent years. The due date for final returns on ceasing business is thirty days after business ceases.

⁹ L. 1953, C. 723, effective April 14, 1953.

¹⁰ L. 1953, C. 733, effective July 1, 1953.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

1953 Amendments to the New York State Unemployment Insurance Law

Principal Stockholders

In January of this year a complaint was received by our State Tax Committee and referred to this department. It was pointed out that the demands of the State are onerous and unnecessary with regard to the filing of information required of employers desiring to pay New York State Unemployment Insurance Contributions on the taxable wages of principal stockholder employees (employees each of whom owned more than 25% of the employer's capital stock).

As a result of the amendment to the law, the tax on a principal stockholder's earnings will be payable quarterly, instead of under the annual method of payment which led to the complications causing the complaints. The first quarterly payment will be due October 31st, on earnings in the July-September quarter. If a principal stockholder earns less than \$3,000 in the last six months of 1953, the firm will be liable at the end of the year for an annual tax on his additional earnings in the first six months, up to a total of \$3,000 taxable wages for the entire year.

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

The amendment requires that the tax be paid on the earnings of principal stockholders only if the firm is subject to the Federal Unemployment Tax Act. The annual Federal Unemployment Tax must be paid by every employer who had 8 or more employees on at least one day of each of 20 calendar weeks in a calendar year.

Unemployment insurance protection will be extended once again to principal stockholders. They had been deprived of protection as a result of the "principal stockholder" amendments of 1951.

Change in Method of Reporting Tips in Certain Situations

Some tax relief is given to a special group of employers, such as summer hotel and restaurant operators, subject to the Federal Unemployment Insurance Tax. Under the Federal law tips and gratuities received in the course of employment by employees, such as waiters, chambermaids, etc., are not subject to either Social Security or Federal Unemployment taxes. Under the State law tips are taxable remuneration for Unemployment Insurance contributions. Under the Federal law earnings of students as well as dismissal wages are subject to tax.

Pursuant to an amendment enacted last year, annual tax payments are required under the New York State law on dismissal wages, if part of the first \$3,000 paid to a dismissed employee during the calendar year. The compensation paid for services during all or any part of the school year or regular vacation period of any person actually in regular attendance during the day-

time as a student at an institution of learning, is likewise taxable, provided the employer is also subject to Federal Unemployment taxes. If the employer is not subject to the Federal Unemployment Tax, then no contributions need be made to the New York State Unemployment Insurance Fund on the dismissal wages or students' wages.

The 1953 amendment to the New York State Unemployment Insurance law provides some benefit for employers subject to the Federal Unemployment Insurance Tax who during the calendar year employ students or pay dismissal wages, and also have on their payrolls employees receiving tips as part of their wages. They will continue to report tips as part of the taxable wages of their employees at the end of each calendar quarter. At the end of the year, the only time when taxes on students' and dismissal wages are payable, they will be permitted to deduct from such wages the amount of tips on which they have paid State taxes.

Late Wage Report \$10 Penalties

The L.O. 12 Wage Report Inquiry has been the subject of much criticism on the part of accountants and employers. The efforts on the part of the Society's Committee on State Taxation to secure some relief from the penalty provisions of the law in this connection were unsuccessful this year. Another amendment makes it even more important that accountants once again call to the attention of their clients the necessity of making prompt reply to the L.O. 12 Wage Report inquiry or suffer a \$10 penalty for failure to reply before 7 days from the mailing date stamped on the form by the Unemployment Insurance Division. The law now requires that any employer who receives an inquiry on the L.O. 12 form for an individual who had *not* been employed by the employer, must likewise reply to that effect on the L.O.

12 Report within the 7 days under penalty of a \$10 fine.

Cash Deposits in Appeal Cases

Cash deposits of \$10 in Referee cases and \$25 in Appeal Board cases, required at the present time when an employer appeals from a holding that a benefit claimant is entitled to unemployment insurance, will hereafter be returned if the employer is finally upheld by the courts.

Successor Employers—

Taxable Wages and the \$3,000 Limitation

The requirement that liability for unpaid contributions must have been assumed in order for remuneration paid by a predecessor and successor to be combined for purposes of the \$3,000 taxable wage limitation is now deleted from the law. Heretofore, unless the successor assumed the obligation for all the predecessor's unpaid contributions, the successor had to pay contributions on the earnings of all of his employees anew, even though these employees had earned more than \$3,000 during the calendar year with the predecessor.

Unemployment Insurance Tax Relief for Certain Veterans' Organizations

A recent decision of the Court of Appeals affirmed the Industrial Commissioner in holding that veterans' organizations like the Veterans of Foreign Wars and the American Legion Posts were not exempt from Unemployment Insurance taxes. The amendment provides that veteran organizations cannot be required to pay contributions for periods prior to 1952. They are not entitled to refunds on contributions already paid for such periods. The purpose of this measure is to wipe out any liability for unemployment insurance contributions, retroactive to 1936.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

C.P.A. Office Managers' Discussions

At the April meeting of accountants' office managers the following were the two most important subjects discussed:

1. Field supervision of audits:

The importance of supervision of audits on the job was stressed in a discussion of methods that are employed for that purpose. In small and medium-sized firms there may be many instances where, once a job is initiated by a partner, subsequent field supervision may be inadequate. True, working papers are reviewed, the audit program (if a written one is used) is scrutinized, and the auditor may even be interrogated occasionally in the office. All of these procedures are not sufficient without an occasional visit to the job, while it is in process, by a partner or by a qualified staff member. Such a visit will provide opportunities to observe the men at work, their procedures, the condition of the records, and to discuss audit procedures and internal control right on the spot where everything can actually be seen.

MAX BLOCK, C.P.A. (N. Y., Pa.), is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

There will be instances where excessive detailed work may be detected, or the converse, inadequate attention, may be observed. Short cuts in bookkeeping and clerical procedures, which a less experienced staff man may not recognize, can be detected by a partner or supervising senior.

The use of a supervisor is desirable wherever partners are not in a position to give adequate attention to the conduct of audits. Supervisors usually are heavy seniors who have been in a firm's employ for a considerable period of time. In small and medium-sized firms they could be part-time supervisors, acting as seniors at other times, if necessary. They may also act as troubleshooters, pitching in on a special matter or substituting for a senior who is sick or on vacation. They could also be useful in staff training work, in giving talks to groups or individual staff members.

A supervisor observes not alone what is being done, but how. He should ascertain that the firm's policy as to audit procedures, relations with client's principals and employees, and general conduct are complied with. Moreover, he can be beneficially utilized to review work papers, report drafts, and audit programs on the job, with the advantage of ready access to the records and the staff auditors.

As to the economics of the subject, the cost of a supervisor may be a deterrent in some instances. If consideration is given to the benefits to be derived—relief to overburdened partners, improvement in audit procedures, possible time savings, improved client and

staff relations, possibilities of better fees, etc.,—the extra overhead may well be warranted, and may turn out to be a good investment.

2. Control of tax return preparation:

The methods employed to insure against failure to prepare returns on time were discussed. A majority felt that a double-check method, though more time consuming than a single control, was desirable nevertheless. One of the methods described included the use of individual tax cards, showing client's name, type of tax, and due date, for each return. These cards are used by partners and/or staff men for assignment, for advance notice that a return is to be prepared, and for follow-up purposes. A tickler, by due dates, listing all returns due on a particular date, is used as a double check against the cards. As returns are prepared for mailing the tickler is checked. Thus, tax cards not disposed of, and open spaces in the tickler, both are indications that a return has not yet been sent to the client.

Note: C.P.A. office managers hold a monthly luncheon meeting on the last Tuesday of each month at the Hotel Lexington, Lexington Ave. and 48th Street, New York City.

Mechanical Reproduction of New York City Tax Returns

Steps will soon be taken to request the approval of the New York City tax authorities for the filing of tax returns on reproduced forms, similar to the authority granted by the Commissioner of Internal Revenue. Large numbers of gross receipts tax returns are prepared by New York City accountants for their local clients. Accordingly, those accountants who now use reproduction machines for federal tax returns may be able to make further use of that equipment.

The request will be handled by David Zack, C.P.A., Chairman of the Society's Committee on Municipal Taxes.

Accountants' Fees

A very well attended meeting of the Individual Practitioners' Committee was held recently. The major subject discussed was accountants' fees. Rates used by practitioners in specific staff size and age of firm categories, determined by a survey, were discussed. The material will probably be publicized by the Committee, together with observations thereon.



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